OPTING INTO THE BANKING UNION BEFORE EURO ADOPTION[1]

Summary

The main motivation for establishing the Banking Union (BU) was the need to reverse financial fragmentation that crippled monetary transmission within the common currency area in the wake of the euro crisis. By design, the BU would raise the credibility of the euro area bank supervision, eliminate distinction between home and host supervisors, and sever the link between banks and sovereigns. This would, in turn, lead to lower bank compliance costs, lower barriers to cross-border activity, and lower funding costs for banks under the BU. As host countries of euro area banks, the NMS-6 would benefit from improved resilience of the euro area financial system and lower funding costs for parent banks.

The full benefits of the BU will be realized once all its elements are in place, which is not yet the case. Most notably an effective common backstop is still needed to break the sovereign-bank links. Furthermore, there is **no equal treatment of the eurozone and non-eurozone members of the BU** with regards to their role in the Single Supervisory Mechanism (SSM), access to common (ECB) liquidity support or to a common fiscal backstop (with ESM currently acting as *de facto* common fiscal backstop for euro area banks).

When would opting into the BU make sense for the NMS-6? For those new member states (NMS) that have set a target date for euro adoption (Romania), this amounts to choosing to frontload the phase-in of some of the necessary institutional changes. For others, the BU opt-in decision requires a careful consideration of country characteristics, policy preferences as well as BU's modalities and implementation:

- ***BU design***: the lack of equal (or fully equivalent) treatment of euro area and non-euro area members of the BU tilts the NMS-6's decision against early BU opt-in and in favor of waiting until euro adoption.
- ***BU modalities***: the lack of clarity on and experience with the BU operational modalities – which may affect macroprudential and possibly monetary policy space of the NMS-6 – may be another factor in favor of waiting. This, in particular, applies to coordination between the BU and local supervisors, as well as to coordination between prudential policies at the national and BU-levels and national monetary policies.
- ***Some may still opt into the BU*** because for them the BU participation may be a way to address specific challenges, which outweigh other considerations, including BU shortcomings. Notably, some may see BU as a way to enhance quality and credibility of bank supervision or to gain access to larger industry-funded common backstop.

The BU opt-in would be more attractive for the NMS-6 if mechanisms were in place to ensure that the NMS-6's concerns stemming from unequal treatment of opt-ins and euro area members are fully addressed. Furthermore, greater clarity on the BU operational modalities – that would shape the opt-ins' policy space and the support they could expect from common euro area institutions — is needed in order for the NMS-6 to make a more informed decision on the BU opt-in.

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[1] Prepared by John Bluedorn, Anna Ilyina and Plamen Iossifov (all IMF). Min Song and Jessie Yang provided research assistance. The authors are grateful to Mr. Hampl (the Czech National Bank), Mr. Voinea (National Bank of Romania), Ms. Szombati (Hungarian National Bank) and Ms. Field (ECB) who participated as discussants in the session on opting into the Banking Union before euro adoption at the New Member States (NMS) Policy Forum in Warsaw on December 12, 2014, and to the NMS-6, EC and ECB representatives who provided comments during bilateral discussions in November 2014. The authors are grateful to Giovanni Dell'Ariccia (IMF) for helpful discussions.

A. Why Did Europe Need a Banking Union?

"With a European supervisor, borders will not matter. Issues such as protecting national champions or supervisory ring-fencing of liquidity will not be relevant." (M. Draghi)

1. The global financial crisis exposed weaknesses in the EU financial architecture, arising from misalignments between national mandates for financial sector oversight and the EU-wide operations of many market participants:

- ***Negative externalities***: The pursuit of domestic financial stability and competitiveness objectives, as well as resident taxpayer interests can create negative externalities for other EU members, resulting in a sub-optimal Union-wide outcome. One example is the failure of home supervisors of banks with subsidiaries in Central and Eastern Europe to rein in credit expansion in the region, which fueled unsustainable domestic demand booms prior to 2008. Host supervisors' efforts to limit rapid credit growth were circumvented by redirecting borrowers from local subsidiaries to parent banks' headquarters (Hilbers et al, 2005). Another example is the bailout of companies from the financial conglomerate Fortis Group according to their country of incorporation, instead of restructuring on a consolidated basis (BIS, 2010).

- ***Financial fragmentation***: The national nature of deposit insurance schemes and public backstops for financial institutions led to a post-crisis fragmentation of the European market for financial services, as the funding costs of financial intermediaries and ultimately the cost of borrowing became linked to sovereign creditworthiness (ECB, 2012). As a result, a number of countries became caught in a negative feedback loop between bank solvency and sovereign default risks, posing a major challenge for euro area countries which do not have country-specific monetary autonomy (IMF, 2013a).

2. In the aftermath of the crisis, the EU embarked on ambitious financial sector reforms aimed at improving the transparency and health of the financial system, strengthening and harmonizing bank supervision and resolution, reducing market fragmentation, and minimizing the cost to taxpayers of future bail-outs. Given the special challenges faced by euro area members, the reform strategy has proceeded along two parallel tracks:

- **Harmonization of the regulatory and supervisory regimes** for all participants in the single market for financial services. To this end, the European System of Financial Supervision (ESFS) was put in place in 2011 and the Single Rulebook was developed to harmonize prudential norms for all EU banks (EC, 2013):

- The *European System of Financial Supervision* comprises the European Banking Authority (EBA), the European Systemic Risk Board (ESRB) [2], European Securities and Markets Authority (ESMA), European Insurance and Occupational Pensions Authority (EIOPA), the Joint Committee of the European Supervisory Authorities (ESAs), and national supervisory agencies.

- The core of the *Single Rulebook* is now in place, although some elements are to be phased in gradually over time. The *Capital Requirements Directive* (CRD IV) and the *Capital Requirements Regulation* (CRR)—which harmonize capital definitions and implement Basel III—were adopted in mid-2013. Work is ongoing on binding technical standards for implementation of CRD IV/CRR, as well as on other chapters of the rulebook, including further harmonization and strengthening of deposit guarantee schemes.

- The *Bank Recovery and Resolution Directive* (BRRD) and *Deposit Guarantee Scheme Directive* (DGSD) were adopted in mid-2014. BRRD establishes baseline bank restructuring and resolution procedures for EU member states and critically introduces "bail-in" of bank liabilities (conversion of liabilities to equity) as a means of reducing the contingent liability for taxpayers (bailouts) in cases of resolution. Similarly, DGSD sets out minimal requirements for the operation of national deposit guarantee schemes, ensuring they are funded *ex ante* and pay out in a timely manner when needed.

- The next step is the development of a Single Supervisory Handbook and further harmonization of supervisory practices to ensure the uniform implementation of the Single Rulebook.

- **Building upon the EU-wide reforms above, euro area countries established common bank supervision and resolution regimes—*Banking Union (BU)*—which is open to non-euro area EU member states.** The architecture of the BU includes the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), which centralize bank supervision and resolution powers. Importantly, the other key elements of the BU —a truly common fiscal backstop and a common deposit guarantee scheme – are not yet in place.

The rest of this chapter focuses on **the pros and cons of participating in the BU prior to euro adoption for the NMS-6** that are members of the EU, but are not yet part of the euro area.

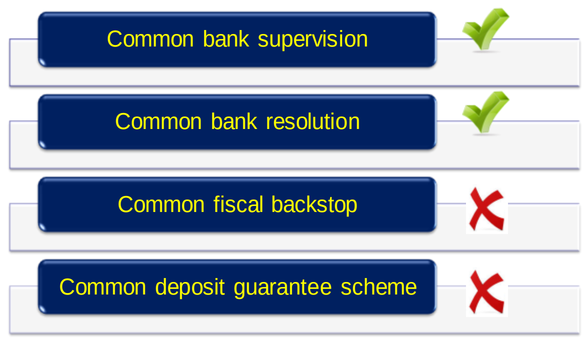
[2] The ESRB is responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability arising from developments within the financial system (ESRB Regulation). The ESRB is also tasked with assessing national macroprudential frameworks and ensuring effective coordination and internalization of cross-border spillovers. However, it does not have enforcement powers.

B. Banking Union Modalities and What an Early "Opt-In" Entails

"We have to consider that opt-in countries, as opposed to their partners from the euro area, don't have equal rights in the Banking Union". (M. Belka)

3. **Despite significant progress, not all elements of the BU are yet in place**. While both SSM and SRM are now operational, an effective common fiscal backstop is still needed to break the sovereign-bank links (though ESM is currently acting as *de facto* common fiscal backstop for euro area banks – see Box 1 for discussion of the BU modalities). Other key elements include allowing the Single Resolution Fund (SRF) (which will be fully funded and mutualized only by 2024) to borrow against future industry levies and working towards a pan-European deposit guarantee scheme (DGS)[3].

Not Yet a Perfect Banking Union



What does "opting into the BU" entail?

4. **The BU membership refers to participation in the Single Supervisory Mechanism (SSM) <u>and</u> the Single Resolution Mechanism (SRM)**. For non-euro area countries, "opting into the BU" would entail entering into a *close cooperation with the ECB* (Article 7 of the SSM Regulation) and passing any required national legislation to enable national authorities to work with the ECB and the Single Resolution Board (SRB) under their supranational frameworks for supervision and resolution:

- *Entry into close cooperation with the ECB.* The ECB assesses the applying member's transposition into national laws of the relevant EU legislation, and can request additional information for the purposes of the envisioned comprehensive assessment of banks. Whereas the outcome of the application is not conditional on the results from the comprehensive assessment, the ECB can, to a certain extent, use its powers to request further information and carry out its own comprehensive assessment, as levers to steer the process.

- *Exit option for non-euro area members*: Unlike members of the euro area, non-euro area participating member states have the option to suspend or terminate the close cooperation with the ECB, and thus their participation in the BU. At the same time, the ECB also has the option to

[3] The proper functioning of the SRM will depend on whether there is adequate backstop. Yet the SRF is not yet fully in place. All banks in the BU countries will contribute to the SRF as from 2016 and this Fund will only amount to €55 billion by 2024. Moreover, banking union also presupposes a common deposit insurance scheme, which does not (yet) exist. So far, there is only a voluntary mechanism of mutual borrowing between deposit guarantee schemes from different EU member states.

suspend or terminate close cooperation with a non-euro area participating member state, if it is determined that the member is not fulfilling their obligations. Resolution actions undertaken prior to becoming a participating member state would not be covered by the SRM.

5. Acting as a *de facto* common fiscal backstop, *ESM bank recapitalization will not be available for any non-euro area BU participants*, since the ESM Treaty is only open to currency union members. The lack of an effective common fiscal backstop means that sovereign and bank risks can become intertwined, especially in times of stress.

Participation in the SSM and SRM

6. After opting into the BU, non-eurozone members would have representation on the Supervisory Board (SB) (on par with the euro area member states)[4], but the modalities of their participation in the decision-making process would differ from the eurozone members. Within the SSM, the SB will manage oversight and make draft decisions. The draft decisions will be referred to the ECB Governing Council, as the overarching authority, that can either automatically adopt the decision under a "*non-objection procedure*" or object to it (see Box 2 for details on the SSM modalities). The non-euro area member states of the BU – *who do not have representation on the ECB Governing Council* – would be invited to send representatives to the ECB Governing Council, if the ECB contemplates an objection to an SB draft decision or if the non-eurozone members disagree with a draft decision of the SB. If no satisfactory compromise can be found in the subsequent reconciliation process, the non-euro area member state can notify the ECB that it will not be bound by such decision. If the "*reasoned disagreement*" with the decision is not accepted, this can result in the eventual suspension or termination of the member state's cooperation with the ECB in the SSM (per Article 7, SSM Regulation).

7. After opting into the BU, non-eurozone members would also have representation on the *Single Resolution Board* (SRB) and would contribute to and have access to the *Single Resolution Fund* (SRF) (see Box 3 for details on the SRM modalities).

Emergency Liquidity Assistance (ELA)

8. Central bank provision of ELA is not affected by the BRRD or by the SRM, as it was and remains a national prerogative. ELA is extended to solvent institutions (that is, those without a capital shortfall identified by the supervisor), subject, *inter alia,* to systemic importance and interconnectedness considerations. These rules are applicable to all EU members.[5] However, for BU-participating states, it will be the ECB in its supervisory capacity under the SSM that will determine

[4] The SSB includes one representative from each member state plus 5 ECB representatives (in their personal capacity) – see Box 2.

[5] See the European Commission's state aid rules as of July 2013 (Article 5 of Communication 2013/C 216/01) for further details.

whether a bank is solvent or not, and thus its eligibility for ELA. Importantly, unlike eurozone members, *non-euro area BU participating members would not be entitled to supplementary access to the ECB's liquidity facilities*. At present, any liquidity provision by the ECB to non-euro area members via repo or swap lines is granted on a country-by-country basis and subjugated to monetary policy considerations.

- ***Key takeaways:*** **the modalities of the non-eurozone members' participation in the BU are notably different from those of the euro-area members**: (i) *role in the SSM*: non-euro countries are not members of the ECB's Governing Council that is charged with adopting decisions drafted by the Supervisory Board; (ii) *fiscal backstop*: non-euro area opt-ins are not eligible for direct bank recapitalization from the ESM (acting as *de facto* common fiscal backstop); and (iii) *liquidity support*: non-euro area opt-ins would not automatically have access to the ECB liquidity facilities. That said, as a compensation for this unequal treatment, the *BU offers some safeguards for the non-euro area opt-ins, such as the possibility to present "reasoned disagreement" and to exit the BU.*

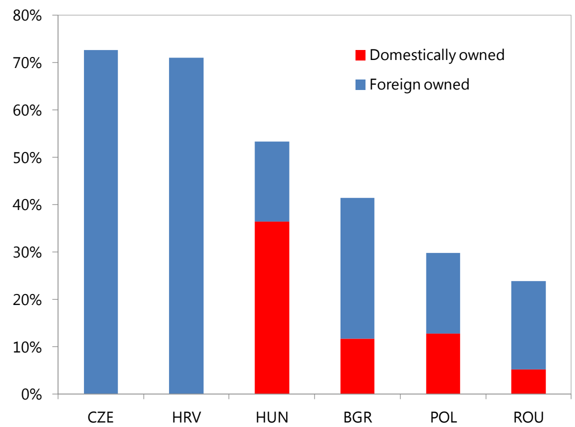
9. Certain features of their banking systems suggest that the NMS-6 would be particularly sensitive to the lack of equal (or fully equivalent) treatment within the BU:

- *Ability to influence decisions related to parent banks is critical for the NMS-6* because most of their banking systems are dominated by euro area bank subsidiaries, which tend to be more important for local economies than for the parent banking groups (see text charts). If under the BU all/most *barriers to cross-border transfers* of capital and liquidity are indeed removed, this also means that local authorities would have less power to ring-fence. The latter raises the importance of being able to influence the activities of parent banks through other means, including via participation in the SSM decision-making process. Given that any decision regarding cross-border banks will have to weigh prudential considerations of host and home countries, any weakness in the ability to influence such decisions raises concerns that these decisions may be tilted in favor of larger financial systems/institutions which have a greater bearing on the financial stability of the BU as a whole.
- *Access to common liquidity and fiscal backstops is important for the NMS-6*, because: (i) many still have large external liabilities, though many NMS subsidiaries are now less reliant on foreign parent bank funding than before the crisis (see Box 1 in the staff report); and (ii) banks in NMS-6 typically have less bail-inable funding (other than uninsured deposits) than eurozone banking groups operating in the region. NMS-6 are, therefore, more likely to benefit from the risk-sharing aspect of the SRF or other common backstop (see chart below).

10. At this stage, it is not clear how effective the safeguards for the non-euro area opt-ns would be. Given that the SSM has been set up very recently and there is yet no experience with the process, there are different views on whether the modalities of the BU opt-ins' participation in the

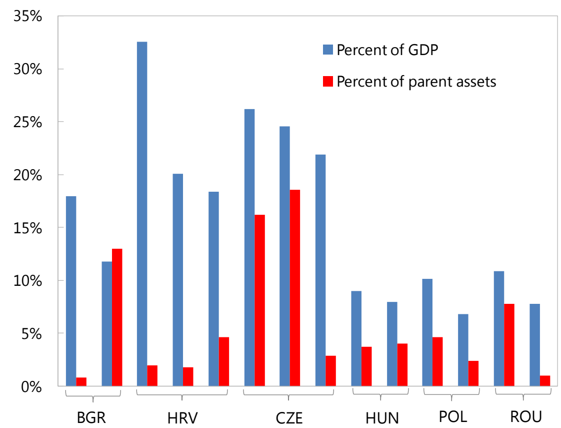
SSM decision-making process can adequately protect their interests.[6] The exit clause may not be an effective safeguard, if it is not used in practice due to significant negative reputational effects. The question of whether, on balance, the opt-ins would gain or lose influence on decisions regarding parent banks is complex and is discussed in more details below.

Three largest banks by assets, 2013
(Percent of GDP)



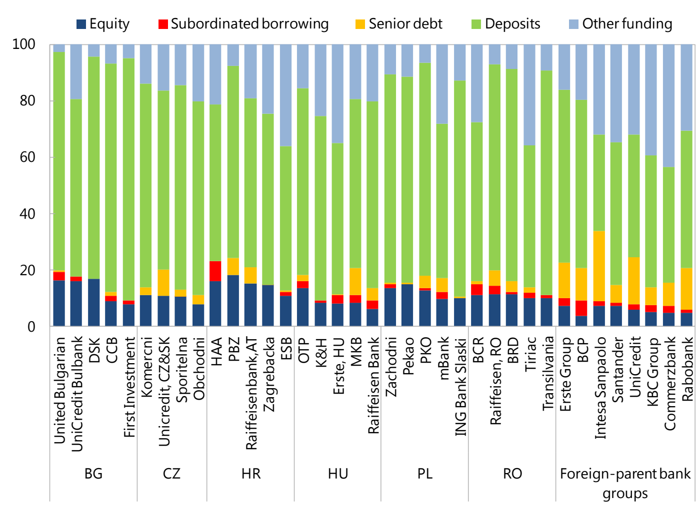
Sources: Bankscope; and IMF staff estimates.
Note: Top 3 banks would be expected to come under SSM.

Assets of largest foreign-owned banks in NMS-6
(Individual bank assets)



Sources: Bankscope; and IMF staff estimates.
Note: In some cases, the source data are consolidated for the financial group, in which the bank is part of.

Funding Structure of Top-5 Banks in NMS-6 and Select Parent Bank Groups, 2013
(Percent of total liabilities)



Sources: Bankscope; and IMF staff calculations.

[6] For example, Tröger (2013) argues that the inability to participate in the ECB's Governing Council's deliberation is important ("it is a significant difference, if a representative of the affected Member State can participate actively in the Governing Council's deliberations or if the Member State has to rely dégagé on the benevolent consideration of a position articulated ex ante"). In contrast, Darvas and Wolff (2013) consider that this mechanism gives the non-euro area participating member a sufficient voice in decision making, since it contains a special opt-out clause in the event of a disagreement with the ECB's decisions in its supervisory role. The NMS-6 survey (see Box 5 in the main report) suggests that this is source of discomfort for many NMS-6.

Macroprudential Policy Space and Policy Coordination

11. The CRR/CRD IV legislative package defines a range of tools over which national macro-prudential authorities may set stricter requirements (above the industry-wide, micro-prudential minima) based on systemic risk considerations, macro-prudential concerns, or to address risks at individual firm level. *National macroprudential authorities retain full control over macroprudential measures, not specified in Union law*, such as the loan-to-value and debt-to-income ratios, among others (see Box 4).

12. All EU member states are required to notify the ESRB of changes in their macroprudential policy stance. The ESRB then provides opinions on the proposed policies regarding their financial stability and growth implications (at both the national and EU levels). Member states are not required to follow the ESRB's recommendations, but the requirement to explain measures, questioned by the ESRB, introduces an additional, albeit soft, check-and-balance.

13. For BU members, the SSM entails some additional constraints on macroprudential policies. Under the SSM Regulation (Article 5), national competent authorities (NCAs) can still deploy macroprudential measures as they deem appropriate, subject to a notification requirement to the ESRB.[7] However, in the case of CRR/CRD IV measures (see Box 4), BU-participating states must also notify the ECB of their intention 10 working days prior to issuance of their decision. If the ECB objects, then it supplies a written explanation within 5 working days, which the national authority must take into consideration. Furthermore, if the ECB wishes, it may apply stricter macroprudential requirements on banks, irrespective of whether they are under direct SSM supervision or not, than the national authorities (subject to similar notification and consideration timelines). In other words, there is an asymmetry in the ability of the ECB to intervene in a participating member state's macroprudential policies —the ECB may always strengthen macroprudential policies set out in relevant Union law, but it cannot compel loosening. On their part, NCAs can also tighten those norms, but cannot loosen them below the ECB's desired minimum.

- ***Key takeaway:*** The extent to which joining the BU would limit macroprudential policy space, unless fully offset by lower likelihood of shocks or additional support from the euro area institutions, would need to be taken into account. At present, a full assessment is complicated by the lack of clarity on and experience with relevant operational modalities of the BU, including the mechanisms for policy coordination between supranational and national levels.

C. Banking Union Opt-In: Pros and Cons for Non-Euro EU Countries

[7] Proposed national measures are analyzed by an Assessment Team consisting of two representatives of the ESRB Secretariat, representatives from nine European Union national central banks, one representative of the ECB, and one representative of the SSM. See the 2013 Annual Report of the ESRB (ESRB, July 2014).

14. The main motivation for establishing the BU was the need to reverse financial fragmentation that crippled monetary transmission within the common currency area in the wake of the euro crisis. The establishment of the SSM (supported by the SRM) would raise the credibility of the euro area bank supervision, eliminate distinction between home and host supervisors for cross-border banks, and sever the link between banks and sovereigns. This is expected to lead to lower bank compliance costs, the removal of any barriers to cross-border activity which may be in place to protect national interests,[8] and lower funding costs for banks under the SSM supervision. That said, the full benefits of the BU will only be realized once all the BU elements are in place (as discussed above).

15. Because of significant presence of euro area banks in all NMS-6 countries, a fully established BU will have positive implications for the NMS-6. As host countries of euro area banks, the NMS-6 would benefit from improved resilience of the euro area financial system and lower funding costs for euro area banks:

- Provided that euro area banks become safer and more conservative (under *more consistent supervision in the BU*), the likelihood of negative spillovers for the NMS-6 from the euro area will be lower.
- Provided the BU will lead to greater fungibility of liquidity within the euro area, the *funding costs for cross-border banking groups will be lower,*[9] which may help boost lending to faster-growing/higher-return NMS.
- *Home-host interactions may become simpler* with the euro area single supervisor. That said, the key question for the NMS is whether the SSM itself, which will supervise most of the cross-border banking groups with operations in the NMS, will treat bank exposures to counterparties inside and outside the BU differently.

16. At present, direct participation in the BU prior to euro adoption is generally less attractive for the NMS-6 than for euro area countries, given that the BU remains incomplete and non-euro area members do not enjoy the same treatment as the euro area members. An imperfect BU could work in practice for euro area countries, given that they have access to the ECB liquidity facilities and to the ESM, but for non-euro area NMS – that do not have either – joining the BU before adopting the euro is less attractive. This is because the amount of decision-making power that they cede to the supranational level would be similar to that of the euro area countries[10], but, in

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[8] Some analysts note, however, that it yet remains to be seen whether the ECB will be able and willing to change the currently reported ring-fencing of banking activities.

[9] Removal of barriers to cross-border transfer of capital and liquidity would reduce the required capital and liquidity buffers at the subsidiary level (see Cerutti and others (2010)).

[10] All banks that come under the SSM supervision have to satisfy the same criteria on systemic significance (Box 1).

return, the NMS-6 would receive less support from common liquidity and fiscal backstops than the euro area countries.

17. In addition to the BU modalities (discussed above), **whether an NMS-6 country would still be better off in the BU than outside would depend on country characteristics, policy preferences and BU's operational modalities** (see Box 5 for discussion of insights from theoretical literature). Some of the key considerations are as follows:

- The NMS-6 *risk-sharing preferences* depend on the country-specific characteristics that affect the types of shocks they are likely to face (e.g., economies that are less integrated with the euro area and hence, more likely to face asymmetric shocks, may derive greater benefits from having access to common backstop).

- The NMS-6 *policy preferences* may influence the desired stringency of prudential standards. While lower incidence of financial instability is growth-enhancing, at any given time, policy makers may have to weigh different considerations when deciding on the "right" level of stringency required to contain systemic risks (e.g., tighter standards reduce the risk and cost of financial instability, but also dampen credit growth and lower bank profitability).[11] The NMS-6 would be more inclined to opt in if they perceive the SSM's preferences to be similar to theirs.

- The *policy space configuration* of the BU opt-ins is yet to be fully defined. The NMS-6 need to consider that joining the BU may affect their macroprudential and monetary policy space.

18. The rest of this section focuses on the **interaction between various country characteristics and BU modalities and provides examples of key trade-offs for different types of countries.** Table 1 presents a taxonomy of country characteristics (top row) and policy objectives (first column) and whether joining the BU could help or hinder the achievement of these objectives (column showing potential benefits and costs). The cells in the matrix indicate which of the country characteristics are likely to be associated with relative benefits or costs. The country characteristics in Table 1 are the ones that are most relevant for the decision to join the common currency area or the common regulatory area based on the literature:

- The degree of *real or financial integration* with the euro area (columns 1 and 3) determines the relative likelihood of common versus asymmetric shocks and hence, risk-sharing preferences.
- The degree of *economic flexibility* (column 2) reflects the ability of the economy to absorb shocks; less flexibility makes it more likely that negative shocks could trigger financial instability.
- The *share of local bank assets owned by the euro area banks* (column 4) indicates the importance of intra-group cross-border flows of euro area banks for domestic financial stability.

[11]The relative weights that national authorities place on different considerations may vary across countries, depending on the institutional setup of financial sector oversight (its independence and accountability), the type of financial system (bank versus market-based), ownership of the banking sector , the degree of market concentration. Weights may change through the cycle.

- The *supervisory standards* (column 5) refer to the stringency of rules and quality of supervisory processes at the local level.
- *Local backstops* for the financial system include local DGS (column 6) and fiscal policy space (column 8) and refer to the national capacity to absorb shocks. Their adequacy is inversely related to countries' potential exposure to contingent liabilities, as measured by the ratio of insured deposits to GDP, and the size of public debt relative to GDP.
- *Policy space* indicates the availability and effectiveness of monetary and fiscal policies (columns 7 and 8), as tools for demand management. Policy space can be proxied by the ratio of public debt to GDP, whereas the availability of monetary policies depends on the nominal anchor (exchange rate versus inflation) chosen by the central bank.

Would joining the BU reduce financial stability (FS) risks for the new members?

YES, if joining the BU

- **Improves the overall quality/stringency of supervision**. To the extent that supervision under the SSM will be stricter than current national supervision, banks would be safer and financial stability risks would be lower. This would be the case, if the SSM: (i) sets micro-prudential standards for local banks that are at least as strict as the current standards in force in the new members (see Box 5); and (ii) succeeds in distancing supervision from the influence of local vested interests, especially the "too big to fail" domestically-owned banks (see Box 6). In order for these benefits to accrue, it is critical for the SSM to establish early a strong track record. That said, differences in legal and accounting standards across members would complicate harmonized supervision in the BU. *New members with less stringent supervisory standards and those with weaker local backstops would benefit more* (Table 1, Columns 5, 6, and 8, Ranks: Low).

- **Limits negative externalities stemming from the actions of current BU member banks.** The participation of the non-euro area countries in the BU could further reduce the scope for regulatory arbitrage and leakages of macroprudential measures aimed at safeguarding financial stability in member countries.[12] The possibilities for regulatory arbitrage have already been reduced through the Single Rulebook, but the SSM would ensure compliance through centralized supervision and greater harmonization of supervisory practices. *New members with strong financial links with the euro area, and a significant presence of BU member banks* (Table 1, Columns 3 and 4, Ranks: High), as well as those with *less stringent supervisory standards and weaker local backstops* (Table 1, Columns 5, 6 and 8, Ranks: Low) *would benefit more*.

[12] As discussed in the introduction, the macroprudential measures adopted by the local authorities to slow rapid credit growth in CESEE countries during the pre-crisis boom were often not very effective because they were not matched by similar measures by the home country supervisors of euro area banks operating in CESEE countries.

Table 1. Benefits and Costs of Joining Banking Union for Non-Euro Area Countries

Policy objective		Benefit or Cost of Joining the Banking Union	Real Sector				Financial Sector				Supervision/Backstops				Policy Space			
			(1) Degree of real convergence/ integration with the euro area		(2) Degree of labor & product markets flexibility		(3) Degree of financial integration with the euro area		(4) Banking system structure (share of banks owned by euro area banks)		(5) Supervisory standards		(6) Industry-funded backstops (DGS)		(7) Monetary		(8) Fiscal	
			High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
Financial stability	*Likelihood of distress*	1. Improve the overall quality of supervision										+		+				+
Financial stability	*Likelihood of distress*	2. Limit negative externalities from euro area banks					+		+			+		+				+
Financial stability	*Likelihood of distress*	3. Increased access to info and improved home-host coordination through SSM					+		+									
Financial stability	*Likelihood of distress*	4. Reduce ability to mitigate country specific shocks		-		-		-		-	-							
Financial stability	*Likelihood of distress*	5. Constrain ability to control cross-border intra-group flows					-		-		-							
Financial stability	*Cost of distress*	6. Increase efficiency and lower cost of cross-border bank resolution							+									
Financial stability	*Cost of distress*	7. Provide access to common, industry-funded backstop (SRF)		+		+		+						+				+
Financial stability	*Cost of distress*	8. Loss of some local control over resolution process in the absence of fiscal backstops							-		-			-				-
Growth		9. Reduce ability to smooth credit cycles through prudential measures		-		-		-		-	-					-		

Note: The table presents a simplified taxonomy of country characteristics (top row) and policy objectives (first column) and whether joining the BU could help or hinder the achievement of these objectives (rows showing potential benefits and costs). The cells in the matrix indicate whether country's ranking on a given country characteristic (in columns) has a material impact on the benefits or costs of joining. For example, the degree of real or financial integration with the euro area (columns 1 and 3) affects the relative likelihood of common versus asymmetric shocks, with lower integration = higher likelihood of asymmetric shocks and hence costs of giving up local policy space to respond to them. Types: for each characteristic listed in the top row, a country can be of two types: High – at or above the average across BU members; and Low –below the average across BU members. Payoffs: "-"(extra loss);"+" (added benefit with diagonal stripes indicating only partial benefit during transition to full SRF mutualization; and "blank" (particular benefit or cost of joining accrues independent of whether a country ranks low or high on a particular country characteristic).

- **Better access to information and better home-host coordination through direct participation in the SSM.**[13] Joining the BU would provide non-eurozone members: (i) greater access to supervisory information on cross-border banks operating in their jurisdictions (and also in other jurisdictions);[14] and (ii) ability to directly participate in the SSM/SB decision making process, though acting in their personal capacities for the good of the Union, rather than for national or group interests. There is a range of views on whether this would ultimately give NMS greater leverage over decisions regarding parent banks. On the one hand, as a member of the SB, the NMS representative would be able to vote on *all issues*, including the ones that are currently beyond the purview of local supervisors.[15] On the other hand, because of different treatment of the euro area and non-euro area members of the SSM (discussed above), the ability of NMS to influence decisions may be weaker than that of the euro area members. Another important issue is that after opting into the BU, the new member would no longer have the final say on certain matters that are of particular importance to them (e.g., local liquidity requirements –see below). Hence, the net gain/loss of influence on the decisions regarding parent banks would depend not only on the NMS' role in the SSM, but also on how much control the new member will *de facto* cede by joining the BU. *New members with strong financial links with the euro area and a significant presence of the BU member banks would benefit* (Table 1, Columns: 3 and 4, Rank: High).

NOT necessarily, if joining the BU

- **Limits the ability to use prudential tools to address country specific shocks**, to the extent that the loss of powers in not compensated by a commensurate decline in the frequency or size of such shocks. Under the Single Rulebook, local supervisors have significant flexibility to impose additional macro- and microprudential requirements, early intervention powers and ability to set conditions under which the local CB could provide liquidity assistance to troubled banks. After joining the SSM, some of this flexibility (including "good" discretion) could be lost. For example, in the event a NMS is hit by an asymmetric shock, SSM's prudential requirements may end up being stricter than might be warranted given country-specific circumstances, which could lead to

[13] Prior to the BU, cross-border coordination of banking supervision of a banking group would occur via a college of supervisors, involving supervisors from those jurisdictions spanned by the group. The college would provide a venue for interactions between supervisors across countries to facilitate information sharing and coordination (particularly in emergencies or cases of restructuring or resolution). A key innovation of the BU is the removal of this institutional layer for coordination between its members.

[14] Being part of the supervisory college, non-euro area member can request any information about parent banks that it deems relevant. Because there is a need to request information, access to information may not always be as timely as desired. In comparison, being part of the SSM would automatically grant access to all info about the parent bank as well as other euro area banks.

[15] Currently, the extent to which local supervisor is able to influence any given decision depends on the specific issue under consideration and who has competency over this issue. E.g., in the case of capital/liquidity requirements at the group level, if a home supervisor decides to increase the requirements for the whole group, the host supervisor cannot block this decision; in the case of capital/liquidity requirements at the subsidiary level, the host supervisor has the final say.

higher (than optimal) incidence of bank closures or to lower recovery values on distressed assets (less of "good forbearance"). *This consideration is most relevant for countries that are relatively less integrated with the euro area and hence more exposed to asymmetric shocks (*Table 1, Columns 1 to 4, Ranks: Low*), as well as for supervisors with greater capacity to intervene* (Table 1, Column 5, Rank: High).

- **Leads to loss of full control over cross-border capital and liquidity flows**, to the extent that the loss of powers in not compensated by a commensurate reduction in the likelihood of negative spillovers or in the absence of alternative mechanisms for dealing with such spillovers. Ring-fencing of capital and liquidity of the euro area banks' subsidiaries was used by national supervisors during the crisis to prevent problems in foreign parent banks from spilling over to the domestic banking systems. After joining the BU, local supervisors will lose control over the liquidity requirements at the subsidiary level, though they will retain the ability to set large exposure limits.[16] To the extent that BU would completely eliminate any negative externalities, the NMS supervisor should not be concerned about losing the ability to ring-fence after joining the BU. However, to the extent that some spillovers remain a possibility, national supervisors may perceive a loss of control over cross-border intra-group flows as potentially increasing the risk of financial instability. *These considerations are most relevant for counties where the euro area banks' subsidiaries dominate in the local banking market* (Table 1, Columns 3and 4, Ranks: High), *as well as for supervisors with greater capacity to intervene* (Table 1, Column 5, Rank: High).

Would joining the BU reduce the cost of financial distress, once it occurs?

YES, if joining the BU

- **Increases efficiency and reduces the cost of bank resolution**. The BRRD already goes some way towards achieving this objective, but the SRM further ensures that the process of winding down of large cross-border banks is orderly and "least cost" on a consolidated basis. *This is a positive factor for all, but especially for those countries that host subsidiaries of euro area banks* (Table 1, Column 4, Rank: High).

- **Provides access to common backstop** (SRF). Joining the SRM allows the NMS banks to have access to a larger backstop without adding to the fiscal burden of the sovereign. Having access to a common backstop (SRF) would be relatively more attractive for countries that are more likely to be hit by asymmetric shocks and those with *weaker local backstops*.[17] However, these

[16] While in a BU it will be much harder for host supervisors to block intra-group cross-border transfers, there are still some powers that are given to member states that could be viewed as safeguards. E.g., there is large exposure regime in the CRR and there are two discretions: one given to supervisor and the one that allows member states to impose large exposure limits (Article 493). The supervisory decision can never overrule the decision of a member state.

[17] The logic is similar to that of the optimal currency area literature. In the Mundell II models (surveyed in Tavlas, 1993 and McKinnon, 2004), differences in economic structure, lack of diversification, and high volatility of terms-of-

(continued)

benefits are limited until the SRF is fully mutualized. The national contributions to the SRF will be only gradually mutualized over the course of the next eight years, reducing the appeal of this aspect of BU membership in the interim. *Hence, less integrated countries* (Table 1, Columns 1 to 3, Ranks: Low) *and those with weaker local backstops* (Table 1, Columns 6 and 8, Ranks: Low) *would derive the biggest benefit once the fully mutualized backstop is in place*.

NOT necessarily, if joining the BU

- **Leads to some loss of local control over the resolution process, without commensurate risk-sharing on supra-national level.** Once a non-EA member joins the SRF, the decision on whether or not to resolve a bank under SSM supervision will be taken at the BU level. Until the SRF is fully mutualized, this raises the risk that the resolution decision may not fully take into account available financing (for resolution purposes), as the latter would still largely consist of local DGS and local fiscal backstop. In addition, there is a risk that the SSM will apply stricter criteria (than might be warranted by local conditions) in determining whether a bank is solvent or not, which would lead to higher incidence of resolution under the BU. *This consideration is most relevant for countries with strong supervision* (Table 1, Column 5, Rank: High), *those in which subsidiaries of cross-border banks that would be resolved directly by the SRM have significant market share* (Table 1, Column 4, Rank: High), *as well as countries with less adequate local backstops* (Table 1, Columns 6 and 8, Ranks: Low).[18]

Would joining the BU facilitate or hinder achieving macroeconomic objectives?

- **Macroeconomic considerations.** Joining the BU could reduce the national policy makers' ability to support access to credit through prudential measures, particularly when country specific circumstances require more supportive financial regulation than in other BU members.[19] This is partly an artifact of the asymmetry between the powers of the ECB and national supervisors to tighten and loosen prudential norms: (i) national prudential norms can only be stricter than the floor set by the ECB; and (ii) the ECB may always strengthen macroprudential policies, but it cannot compel loosening. While in principle, the ECB does not have to set the same macroprudential standards across all BU members, it is not clear how much heterogeneity it may be prepared to accept given its objective of ensuring level playing field and preventing

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trade increase the appeal of a monetary union, as they increase the benefits of pooled foreign reserves and integrated capital markets.

[18] In addition, initial conditions may matter as well. If asset quality, liquidity and profitability of local subsidiaries of euro area banks are stronger than in the rest of the banking group, local stakeholders would be worse off if a banking group is resolved at BU-level (on a consolidated basis) rather through the local resolution process. While this consideration is not relevant in a steady state, it may provide a disincentive to joining the BU from a position of relative strength.

[19] GFSR (2013) notes that during the latest crisis, a number of European countries used prudential measures to enhance credit supply, including a reduction in risk weights for small and medium enterprise loans when calculating banks' capital adequacy ratios, forbearance of nonperforming loans, and countercyclical macroprudential regulations.

regulatory arbitrage. *This consideration is most relevant for less integrated economies that are more likely to find themselves facing different cyclical conditions than the rest of the BU* (Table 1, Columns 1 to 4, Ranks: Low), *as well as for supervisors with greater capacity to intervene* (Table 1, Column 5, Rank: High).

Does monetary policy autonomy make a difference?

19. All BU members, including those in the eurozone, retain some policy instruments (for example, taxes and subsidies, housing policies, and so on) that could potentially be used to offset the impact of measures adopted at the BU level. However, non-euro area members will have an additional tool—they will retain sovereignty over monetary and exchange rate policies.[20] In the BU, these national policies would need to be coordinated not only with prudential measures[21] taken at the national but also at the BU level. Independent monetary policy provides an additional policy tool to manage the impact of shocks on the economy that could, in principle, allow a non-euro area BU member to take advantage of the upsides offered by the BU, while mitigating potential downsides.[22] *Perspective BU members without independent monetary policy will, hence, be at a disadvantage relative to their inflation-targeting peers* (Table 1, Column 7, Rank: Low).

- **Key takeaways:** Looking at purely economic considerations, some NMS-6 may want to opt in because they see potential benefits from addressing specific challenges through participation in the BU as far more important than all other considerations, including BU shortcomings. Notably, some NMS may see BU as a way to enhance quality and credibility of bank supervision or distance local supervision from local vested interests[23] or to gain access to larger common (industry-funded) backstops. In general, the BU opt-in decision is complex, with many moving parts and requires careful consideration of country characteristics, policy preferences and BU's modalities. Some trade-offs are illustrated below:

    - ***Economies that are less integrated with the euro area and hence more likely to find themselves facing different cyclical conditions than the rest of the BU*** *(e.g., Bulgaria,*

[20] Monetary policy remains a national responsibility prior to euro adoption, but is subordinated to EU Treaty obligations. In particular, its main objective should be price stability, with exchange rate policy being treated as a matter of common interest.

[21] E.g., according to the IMF (2013c) monetary policy measures that were adopted during the recent crisis by a number of European countries with the explicit objective of easing constraints on credit supply included direct and indirect credit easing as well as widening of collateral eligibility for private sector assets.

[22] In the more extreme case, the use of monetary policy for financial stability rather than price stability goals may undermine its credibility. There are also other practical policy coordination challenges, such as interaction between multiple central banks (LoLR, collateral requirements) and coordination of monetary and competition policies (see Scherf, 2014).

[23] In Box 4, we infer the policymakers' revealed preference between financial stability and support of domestic banks by the extent to which they allow sizable gains in the market share of domestically-owned banks to occur alongside with these banks paying a bigger premium in funding costs than foreign-owned banks.

Croatia) face a trade-off between gaining access to a larger industry-funded common backstop (SRF) and giving up some flexibility to deal with country specific shocks. While the upside will fully materialize only once the SRF is fully mutualized, the downside can be properly assessed only when there is more clarity on and experience with the relevant BU operational modalities.

- ***Economies where the euro area banks dominate local banking systems*** *(e.g., Czech Republic, Croatia)* face a trade-off between direct participation in the SSM deliberations (which entails better access to information and ability to participate in the decision-making on parent banks) and ceding full control over intra-group cross-border capital and liquidity flows (ability to ring-fence). The big unknown here is the extent to which negative externalities stemming from the activities of the euro area cross-border banks would indeed be effectively eliminated under the BU, as this would determine the value of having control over the intra-group cross-border flows for local authorities.

- **Countries with monetary and exchange rate flexibility** would need to better understand how the centralization of micro- or macroprudential powers under the BU would affect their ability to conduct monetary policy/lender-of-last-resort functions effectively. While the non-eurozone BU opt-ins could, in principle, use their monetary policy/exchange rate flexibility to offset tighter macroprudential requirements set at the BU level, in practice, this could lead to tensions that would need to be resolved.

How would participation by one or more NMS change the "opt-in" calculus for others?

20. The opt-in decision by one NMS may have a bearing on the decision(s) of other NMS(s), if it creates a competitive advantage for the NMS that joins but makes others worse off compared to the status quo. This, however, requires an assumption that there is a limited pool of capital and funding dedicated to the region by the euro area banks, which does not seem plausible. Kisgergely and Szombati (2014) list other reasons why the opt-in decisions of NMS could be interrelated, such as: (1) the possible use of BU-membership, by international capital market participants, as a signaling device of lower systemic risk, with the potential of putting opt-outs' borrowers at a competitive disadvantage; and (2) possible dominance of BU-centric views in EBA and ESRB operations that could marginalize NMS positions on issues.

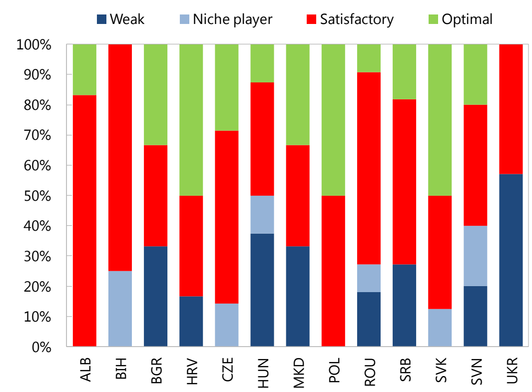
21. Available evidence suggests that host country' risk profile, growth potential and banking system soundness are dominant factors in foreign banks' assets allocation decisions:

- The latest CESEE bank lending survey (charts below) shows that foreign banks have broadly similar views on the Czech and Slovak banking systems, which have similar financial soundness indicators (Box 2 in the main report), despite the fact that one is a member of the euro area/BU and the other is not.

- During the crisis, euro area banks scaled back their exposure to the region, while differentiating across countries based on their risk profiles. Among the NMS-6, banking systems with relatively higher asset quality and profitability, such as Poland and the Czech Republic, managed to attract additional foreign funding, while countries with higher FX-currency mismatches, NPLs and lower profitability experienced significant outflows (see Box 2 in the main report).

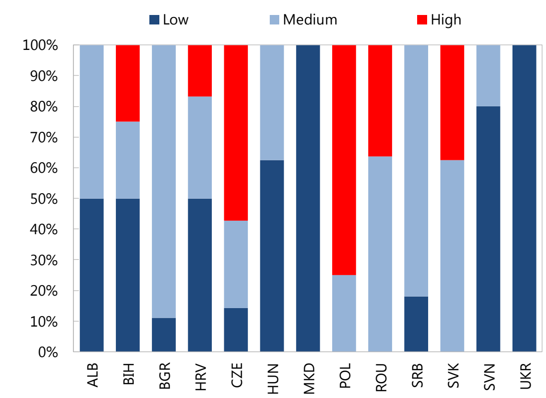
Foreign Banks' Assessment of Market Positioning and Potential across CESEE

Subsidiary current positioning in the market



Sources: EIB, CESEE Bank Lending Survey, H2 2014.

Assessed market potential



Sources: EIB, CESEE Bank Lending Survey, H2 2014.

D. Conclusions

22. For the NMS-6, the calculus of opting into the BU before euro adoption is complex and has many moving parts. The opt-in decision has to take into account a range of economic and political considerations, as well as evolving European financial architecture. For those NMS-6 that already set the date for euro adoption (Romania), an early BU opt-in would simply be a matter of phasing in the necessary institutional adjustments. For those that have not yet decided on the timing of euro adoption, the BU opt-in decision requires a careful consideration of the countries' characteristics, policy preferences/space, as well as greater clarity on the BU implementation.

When would opting into the BU make sense for the NMS-6?

- ***BU design***: the lack of equal (or fully equivalent) treatment of euro area and non-euro area members of the BU (in the areas of representation in the SSM, access to common liquidity and fiscal backstops) tilts the decision against early BU opt-in and in favor of waiting until euro adoption.
- ***BU modalities***: the lack of clarity on and experience with the BU operational modalities may be another factor in favor of waiting. This, in particular, applies to coordination between the SSM and local supervisors, as well as to coordination between prudential policies at the national and BU-levels and national monetary policies.
- ***Some may still opt in*** because for them the BU participation may be a way to address specific challenges, which outweigh all other considerations, including BU shortcomings. Notably, some may see BU as a way to enhance quality and credibility of bank supervision or to gain access to larger industry-funded common backstop.

23. Opting into the BU before euro adoption would be more attractive for the NMS-6 if mechanisms were in place to ensure that the NMS-6's concerns stemming from unequal treatment of opt-ins and euro area members are fully addressed. Furthermore, greater clarity on the BU operational modalities – that would shape the opt-ins' policy space and the support they can expect from common euro area institutions — is needed in order for the NMS-6 to make a more informed decision on the BU opt-in.

Box 1. Key Elements of the Euro Area Banking Union

For member states participating in the BU, there are three key elements:

Single Supervisory Mechanism[1] – Consisting of the ECB and national banking supervisors (the national competent authorities or NCAs), the SSM unifies banking supervision across participating member states (currently, only euro area states). The ECB is the overarching supervisory authority, directly supervising 120 significant banks—jointly comprising almost 85 percent of total euro area bank assets —and overseeing NCAs' supervision of the other 3500 less significant banks in the euro area. The ECB can take over direct supervision of any less significant bank at any time in order to maintain cross-country consistent and high supervisory standards, or if it deems the bank to have become significant.

The ECB, in close cooperation with the NCAs, has carried out the assessment of significance based on the criteria set out in the SSM Regulation and the SSM Framework Regulation, namely:

a) size (total assets exceeding €30 billion);

b) importance for the economy of the EU or any participating Member State (in particular, total assets exceeding €5 billion and 20% of GDP of a Member State);

c) significance of cross-border activities (in particular, if the ratio of its cross-border assets or liabilities to its total assets or liabilities, respectively, is above 20%);

d) a request for, or the receipt of, direct public financial assistance from the European Stability Mechanism (ESM);

e) one of the three most significant credit institutions in a participating Member State.

Single Resolution Mechanism[2] – The SRM refers to the system of national resolution authorities and the central Single Resolution Board (SRB), which is a stand-alone institution. It unifies the bank resolution framework across participating member states. The SRB oversees the resolution of banks by national resolution authorities (which will follow the strictures of BRRD), and directly handles the resolution of large and cross-border banks. From January 2016, it can also draw upon a common, industry-funded backstop called the Single Resolution Fund (SRF), in order to resolve banks under BRRD.[3] The eventual size of the industry backstop is planned at €55 billion (about 1 percent of covered deposits in the euro area).

ESM Direct Bank Recapitalization – In December 2014, euro area member states gave the European Stability Mechanism (ESM) the power to directly recapitalize banks (with up to €60 billion available), mitigating some of the potential fiscal problems associated with ESM indirect bank recapitalization, when a sovereign borrows from the ESM and then funnels those funds into its banking system. ESM bank recapitalization will not be available for any future non-euro area banking union participants, since the ESM Treaty is only open to currency union members. However, even if it were available, there are doubts about its effectiveness as a common fiscal backstop as currently formulated. The hurdles for its use are very high and in the event of systemic crisis, the ceiling on the funding available for recapitalization could be rapidly reached.

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[1] The enabling legislation was adopted in October 2013 by the European Union. To prepare the ground for the SSM, the ECB has undertaken a Comprehensive Assessment of bank balance sheets, with an asset quality review and stress tests.

[2] At the EU level, the enabling legislation was adopted April 2014. The SRM began operating in January 2015, shortly after the SSM.

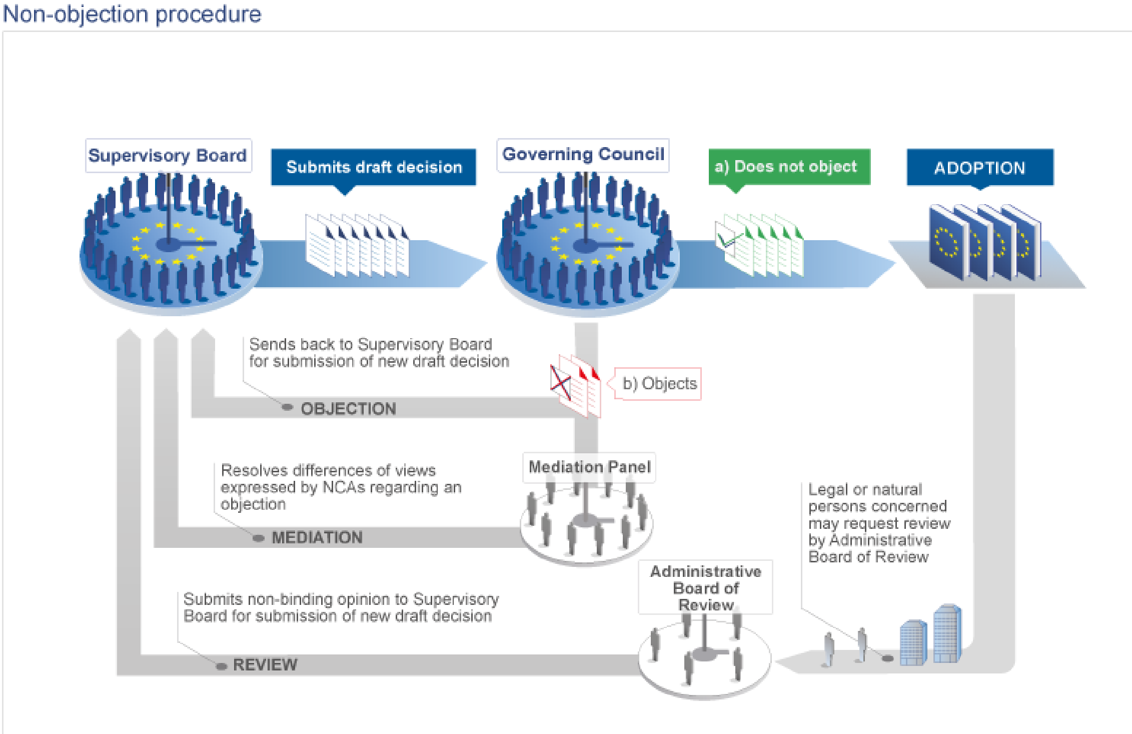
[3] The SRF was adopted by intergovernmental agreement (rather than EU legislation) in May 2014. It will start out with national compartments which build up over time and are gradually mutualized (60 percent mutualized after 2 years, building to 100 percent after 8 years, in 2024).

Box 2. The SSM Modalities

Oversight will be managed by a *Supervisory Board* (SB), based within the ECB, which consists of a chair and vice-chair (the latter also serving on the ECB Executive Board), a single representative from each participating Member States plus four ECB representatives and who are expected to act in their personal capacities for the good of the Union, rather than for national or group interests. In the event that a participating member state's national supervisor is not the national central bank, they may request that a representative of the national central bank also attend. For the purposes of voting however, the representatives of any one member state are considered as one member.

The SB will also make draft decisions, which are then referred to the ECB's *Governing Council* (consisting of ECB Board members and euro area national central bank heads). Regular draft decisions are passed by simple majority, while regulatory decisions with SSM-wide import are passed by qualified majority (Article 26 of the SSM Regulation).[1] The ECB Governing Council then either adopts the decision on a lapse-of-time basis or objects to it. In case a decision is objected to, then it is referred back to the SB for redrafting, or, as an intermediary step, goes to a mediation panel which works to resolve the differences in views across national competent authorities.

Decision-making process of the Single Supervisory Mechanism:
Non-objection procedure



Source: **https://www.bankingsupervision.europa.eu/organisation/governance/html/index.en.html**.

[1] A qualified majority is defined in Article 16(4) of the Treaty on European Union (TEU) and Article 3 of Protocol Number 36 on transitional provisions associated with TEU (reweighted according to the membership of the SSM).

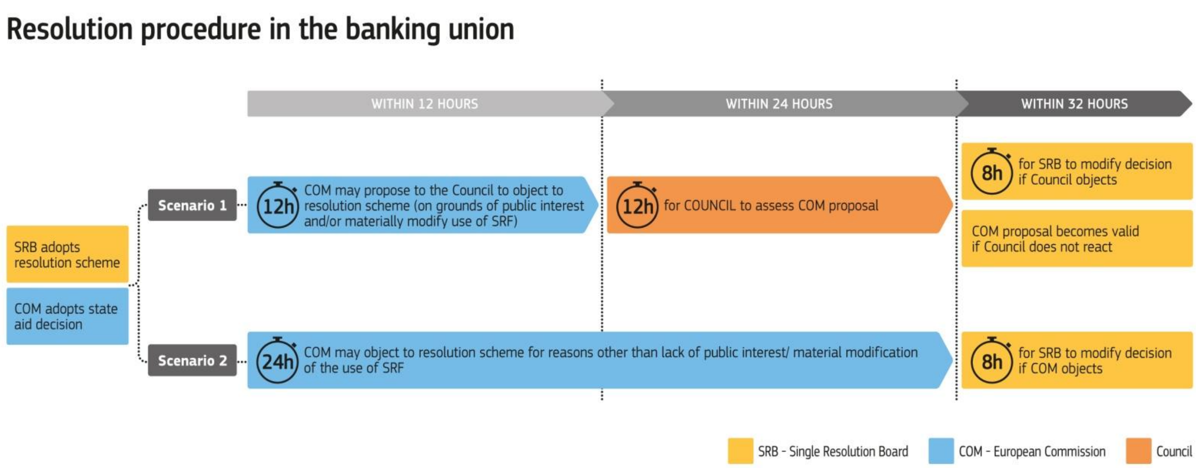
Box 3. The SRM Modalities

Decision-making in the SRM:

The governing body of the SRM is the *Single Resolution Board* (SRB), which consists of a chair, vice-chair, three other full-time members, and one representative from the national resolution authorities of each participating member state. The chair, vice-chair and other full-time members, constituting the *executive of the SRB*, are all appointed by the European Parliament from a short-list of candidates drawn up by the Commission.

Resolution decisions are drafted by the executive of the SRB and are assumed adopted by the SRB unless there is an objection by one of the representatives of the participating member states (similar to the non-objection procedure used by the SSM). In the case of an objection, the SRB meets in plenary (all members) and takes the resolution decision, based on a *simple majority rule*. In general, the plenary SRB meets at least twice a year, to review the budget and assess resolution activity, but it may also meet at the behest of the chair or if more than €5 billion in funds from the SRF have been used in any 12 month period.

The resolution procedure also involves close coordination with the European Commission and the EU Council (see below)



Source: europa.eu/rapid/press-release_MEMO-14-294_en.htm

Contributing to the SRF

Under the SRM Regulation and SRF intergovernmental agreement, all participating member states contribute (whether euro area or not) and are able to access the SRF under the SRM. A bank's *ex ante* contributions to the SRF are calculated *pro rata* with its share of total liabilities minus covered deposits of all banks in participating member states (plus a risk-adjusted contribution drawing upon BRRD criteria; see the SRM Regulation, Article 70).

Box 4. Macroprudential Policy Space for the BU members

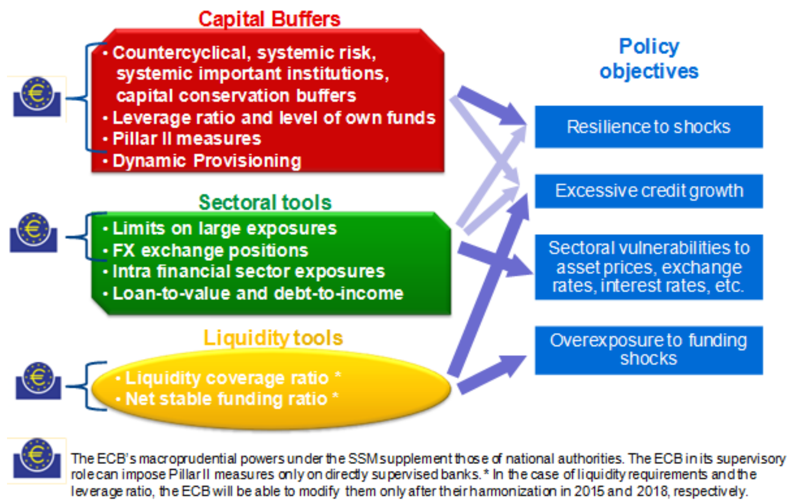
For BU members, the SSM entails some additional constraints on macroprudential policies. Under the SSM Regulation (Article 5), national competent authorities (NCAs) can still deploy macroprudential measures as they deem appropriate, following the usual practice of submitting them to the ESRB for a non-binding opinion. However, in the case of CRR/CRD IV measures (see below), BU-participating states must also notify the ECB of their intention 10 working days prior to issuance of their decision. If the ECB objects, then it supplies a written explanation within 5 working days, which the national authority must take into consideration. Furthermore, if the ECB wishes, it may apply stricter macroprudential requirements on banks, irrespective of whether they are under direct SSM supervision or not, than the national authorities (subject to similar notification and consideration timelines)

The **CRR/CRD IV legislative package** defines a range of tools over which national macro-prudential authorities may set stricter requirements (above the industry-wide, micro-prudential minima) based on systemic risk considerations, macro-prudential concerns, or to address risks at individual firm level. These are subject to a notification requirement to the ESRB and include:

- Pillar I measures—countercyclical capital buffer and additional capital buffers for systemic risk, systemic important institutions, and capital conservation, as well as the leverage ratio and the level of own funds. In addition, national authorities can set higher risk weights on real estate exposures and large exposures;
- Pillar II measures—a wide range of measures at the level of individual institutions or group of institutions with similar risk profile, imposed following a supervisory review and evaluation process aimed at identifying risks they face or pose to the financial system;
- Liquidity provisions—liquidity coverage ratio and net stable funding ratio;
- Limits on large exposures and intra financial sector exposures.

National macroprudential authorities retain control over macroprudential measures, not specified in Union law, such as the loan-to-value and debt-to-income ratios, among others (Chart below). This is subject to a notification requirement to the ESRB and possible intervention by the EU Council. In addition, until the harmonization of the liquidity requirements in 2015 and the leverage ratio in 2018, member states can set unilaterally these measures.

Mapping Macroprudential Tools to Objectives



Source: Authors. Mapping to objectives is based on IMF 2013b.

Box 5. Theoretical Considerations in Designing an Optimal Banking Union

The design of national supervision and safety nets in a multi-country integrated market has to take into account potential cross-border spillovers. Tighter supervision which makes the domestic banking system safer may be good for other countries with which this country has close links, by reducing financial stability risks. But, tighter supervision may also make domestic banks less competitive vis-à-vis foreign banks. This suggests that while there may be incentives for national supervisors in a financially integrated region to cooperate, independent regulators may also have an incentive to promote the competitiveness of domestic banks by lowering their own supervisory standards, which could trigger a "race to the bottom."

When will a centralized solution ("banking union") be preferred by national supervisors as a way to achieve their national policy objectives? The theoretical literature suggests that countries that are highly interlinked and similar in their regulatory preferences will tend to see higher net benefits to coordination, compared to those that are not. But in order for such national supervisors to prefer a banking union, the common standards must be stricter than the ones existing in individual countries (Dell'Ariccia and Marquez, 2006).[1] If however, the initial cross-country differences in supervisory preferences are significant, the centralized solution may not be an optimal choice for all. In more extreme cases, regulatory preferences may be distorted by vested interests of bank shareholders, debtors, and creditors (Scherf, 2014), in which case joining a regulatory union may be a way to reduce "regulatory capture."

Parallels between the decisions to join a banking union and a currency union bring out additional factors pertinent to the decision.[2] In reality, countries that are contemplating joining a banking union may be very different, not only in terms of supervisory preferences, but also along other characteristics, such as their degree of real and financial integration with banking union members, the degree of flexibility of their economies, the structure of their banking systems, as well as the quality of prudential supervision and the level of national backstops. Greater "similarity" between current and prospective banking union members reduces the probability of an idiosyncratic shock driving a wedge between national interests and that of the banking union. But lower supervisory quality and lower backstops at the national level likely increase the benefits of having common (tighter) regulatory/supervisory standards and common (larger) backstops.[3]

[1] "If a country-level regulator is to relinquish its authority and, hence, its ability to set standards optimally given its competitor's choice, it must be compensated by an increase in the capital requirement for its competitor's banks. In other words, a necessary condition for a centralized regulator to emerge endogenously as an agreement between the independent regulators is that the new common regulatory standards represent an increase for both countries." (Dell'Ariccia and Marquez, 2006, p. 413).

[2] See Box 1 in Chapter 1 on "Euro adoption – Macroeconomic Benefits and Challenges."

[3] Recent research in the OCA area highlights the benefits of financial markets integration and of importing prudent economic management by pegging the domestic currency to that of a dominant economic power (see Iossifov and others, 2009 for an overview). In the same vein, a common fiscal backstop in a banking union serves the role of an insurance policy, upon which individual members can draw in the event of an asymmetric shock.

Box 6. Cross-Country Differences in Policymakers' Relative Preference for Promoting Domestic Banks

Countries differ in the quality of bank supervision and the balance between financial stability and support of domestic banks. These two aspects of the policy regime can be, but are not necessarily, linked by the degree of "regulatory capture". The assessment of supervisory quality goes beyond the scope of this paper. But, policymakers' revealed preference for promotion of domestically-owned banks can be inferred from the extent to which domestic banks are allowed to gain market share at the expense of above-average funding costs.

The data suggest that domestic banks in Bulgaria and the Czech Republic, and to a lesser extent Poland and Hungary, rapidly expanded their deposit base in the post-crisis period (see figure in the box). Domestic banks in Bulgaria and Hungary have the largest market shares relative to other NMS-6 countries, whereas in the Czech Republic the market share of domestic banks remains marginal. In addition, domestic banks have higher funding costs than their foreign-owned peers in all NMS-6 countries, with the widest margins recorded in Hungary, Bulgaria, and the Czech Republic.

New Member States: Relative Performance of Domestic- versus Foreign-Owned Banks

	Share of domestic banks in total bank deposits			Cummulative Growth Rate of Deposits 2009-2013			Average cost of funding 2009-2013			Return on equity avg 2008-2013		
	2007	2013	Change, 2007-2013	Domestic banks	Foreign banks	Difference in growth rates (dom. vs frn. banks)	Domestic banks	Foreign banks	Difference in rates (dom. vs frn. banks)	Domestic banks	Foreign banks	Difference in ROE (dom. vs frn. banks)
Bulgaria	21.4	32.1	10.7	133.4	27.4	106.0	4.7	2.9	1.8	5.9	5.7	0.2
Croatia	…	…	…	…	…	…	…	…	…	…	…	…
Czech Republic	1.7	6.4	4.6	167.1	25.1	142.0	2.4	1.4	0.9	9.3	14.1	-4.8
Hungary	41.0	47.0	6.0	14.3	-10.6	24.9	5.5	3.3	2.1	8.5	-6.6	15.0
Poland	32.1	40.2	8.1	79.9	35.8	44.1	3.0	2.6	0.5	11.4	9.2	2.2
Romania	13.5	11.1	-2.4	-7.9	29.6	-37.5	4.4	3.9	0.5	2.4	0.1	2.3

Source: ECB Consolidated Banking Data and Fund staff calculations.
Notes: The cost of funding is estimated as the ratio of interest expenses to the average interest-bearing liabilities (the latter proxied by the difference between total liabilities and equity).

Overall, results suggest that domestic banks in Bulgaria and Hungary might have benefitted from a more favorable policy stance compared to their foreign-owned peers. Domestic banks in Bulgaria and Hungary have the largest market shares relative to other NMS-6 countries, with gains in recent years associated with the payment of a bigger premium in funding costs over foreign-owned banks. In the case of Hungary, the size of the premium is likely driven by foreign-owned banks' interest rate margin policies in response to the government-mandated cost of restructuring of FX-denominated debt.

Appendix I. Largest Banks in NMS-6 and their Ultimate Owners

Table 1. Largest Banks in NMS-6 and their Ultimate Owners

Country	Bank	National rank by assets	Country of global ultimate owner	Name of global ultimate owner	Market share in banking sector loans	Total assets (bil EUR)	Total assets (% of GDP)
Bulgaria	UniCredit Bulbank AD	1	Italy	UNICREDIT SPA	18%	7.18	18%
Bulgaria	DSK Bank Plc	2	Hungary	OTP BANK PLC	13%	4.70	12%
Bulgaria	First Investment Bank AD	3	Bulgaria	FIRST INVESTMENT BANK AD	11%	4.66	12%
Bulgaria	Corporate Commercial Bank AD	4	Bulgaria	MR TSVETAN RADOEV VASILEV	8%	3.58	9%
Bulgaria	United Bulgarian Bank - UBB	5	Greece	HELLENIC FINANCIAL STABILITY FUND	9%	3.56	9%
Bulgaria	Raiffeisenbank (Bulgaria) EAD	6	Austria	RAIFFEISEN LANDESBANKEN HOLDING GMBH	8%	3.16	8%
Bulgaria	Societe Generale Expressbank	7	France	SOCIETE GENERALE SA	6%	2.10	5%
Bulgaria	Central Cooperative Bank AD	8	Liechtenstein	CHIM INVEST ANSTALT	3%	1.99	5%
Bulgaria	CIBANK JSC	9	Belgium	KBC GROEP NV/ KBC GROUPE SA-KBC GROUP	2%	1.10	3%
Bulgaria	Allianz Bank Bulgaria AD-CB Allianz Bulgaria AD	10	Germany	ALLIANZ SE	2%	1.05	3%
Croatia	Zagrebacka Banka dd	1	Italy	UNICREDIT SPA	31%	13.98	33%
Croatia	Privredna Banka Zagreb d.d-Privredna Banka Zagreb Group	2	Italy	INTESA SANPAOLO	18%	8.61	20%
Croatia	Erste & Steiermärkische Bank dd	3	Austria	ERSTE GROUP BANK AG	18%	7.89	18%
Croatia	Raiffeisenbank Austria d.d., Zagreb	4	Austria	RAIFFEISEN LANDESBANKEN HOLDING GMBH	9%	4.91	11%
Croatia	Hypo Alpe-Adria-Bank dd	5	Austria	REPUBLIK OSTERREICH - GOVERNMENT OF AUSTRIA	8%	4.16	10%
Croatia	Societe Generale - Splitska Banka dd	6	France	SOCIÉTÉ GÉNÉRALE	7%	3.71	9%
Croatia	Hrvatska Postanska Bank DD	7	Croatia	GOVERNMENT OF CROATIA	4%	2.52	6%
Croatia	OTP banka Hrvatska dd	8	Hungary	OTP BANK PLC	3%	1.86	4%
Croatia	Sberbank dd	9	Russia	PRAVITELSTVO ROSSIISKOI FEDERATSII	2%	1.26	3%
Croatia	Kreditna Banka Zagreb	10	Croatia	N/A	1%	0.56	1%
Czech Republic	Ceskoslovenska Obchodni Banka A.S.- CSOB	1	Belgium	KBC GROEP NV/ KBC GROUPE SA-KBC GROUP	17%	39.16	26%
Czech Republic	Ceska Sporitelna a.s.	2	Austria	ERSTE GROUP BANK AG	16%	36.66	25%
Czech Republic	Komercni Banka	3	France	SOCIÉTÉ GÉNÉRALE	16%	32.70	22%
Czech Republic	Unicredit Bank Czech Republic and Slovakia AS	4	Italy	UNICREDIT SPA	10%	17.58	12%
Czech Republic	Hypotecni banka a.s.	5	Belgium	KBC GROEP NV/ KBC GROUPE SA-KBC GROUP	6%	8.10	5%
Czech Republic	Raiffeisenbank akciova spolecnost	6	Austria	RAIFFEISEN LANDESBANKEN HOLDING GMBH	5%	7.46	5%
Czech Republic	GE Money Bank as	7	USA	GE CAPITAL INTERNATIONAL HOLDINGS	4%	5.10	3%
Czech Republic	J&T Banka as	8	Slovakia	TECHNO PLUS, A. S.	2%	4.17	3%
Czech Republic	PPF banka a.s.	9	Czech Republic	MR KELLNER PETR	1%	3.98	3%
Czech Republic	Stavební Sporitelna Ceské Sporitelny as	10	Austria	ERSTE GROUP BANK AG	1%	3.76	3%
Hungary	OTP Bank Plc	1	Hungary	OTP BANK PLC	49%	36.24	36%
Hungary	K&H Bank Zrt	2	Belgium	KBC GROEP NV/ KBC GROUPE SA-KBC GROUP	8%	8.95	9%
Hungary	Erste Bank Hungary Nyrt	3	Austria	ERSTE GROUP BANK AG	11%	7.91	8%
Hungary	MKB Bank Zrt	4	Germany	FREISTAAT BAYERN BAYERISCHES STAATSMINISTERIUM DER FINANZEN	10%	6.85	7%
Hungary	Raiffeisen Bank Zrt	5	Austria	RAIFFEISEN LANDESBANKEN HOLDING GMBH	10%	6.46	6%
Hungary	CIB Bank Ltd-CIB Bank Zrt	6	Italy	INTESA SANPAOLO	10%	6.46	6%
Hungary	UniCredit Bank Hungary Zrt	7	Italy	UNICREDIT SPA	7%	6.18	6%
Hungary	OTP Mortgage Bank-OTP Jelzalogbank Rt	8	Hungary	OTP BANK PLC	8%	4.49	5%
Hungary	Budapest Bank Nyrt-Budapest Hitel-és Fejlesztési Bank Nyrt	9	USA	GE CAPITAL INTERNATIONAL FINANCING CORP INC	4%	3.16	3%
Hungary	FHB Mortgage Bank Plc-FHB Jelzalogbank Nyrt.	10	Hungary	FHB MORTGAGE BANK PLC-FHB JELZALOGBANK	3%	2.57	3%
Poland	Powszechna Kasa Oszczednosci Bank Polski SA - PKO BP SA	1	Poland	POWSZECHNA KASA OSZCZEDNOSCI BANK POLSKI SA - PKO BP SA	15%	49.80	13%
Poland	Bank Polska Kasa Opieki SA-Bank Pekao SA	2	Italy	UNICREDIT SPA	10%	39.63	10%
Poland	Bank Zachodni WBK S.A.	3	Spain	BANCO SANTANDER SA	7%	26.52	7%
Poland	mBank SA	4	Germany	COMMERZBANK AG	7%	26.07	7%
Poland	ING Bank Slaski S.A. - Capital Group	5	Netherlands	STICHTING ING AANDELEN	5%	21.69	6%
Poland	Getin Noble Bank SA	6	Poland	GETIN NOBLE BANK SA	5%	15.90	4%
Poland	Bank Millennium	7	Portugal	BANCO COMERCIAL PORTUGUÊS, SA-MILLENNIUM	4%	14.25	4%
Poland	Raiffeisen Bank Polska SA	8	Austria	RAIFFEISEN LANDESBANKEN HOLDING GMBH	4%	13.35	3%
Poland	Bank Handlowy w Warszawie S.A.	9	USA	CITIGROUP INC	2%	11.35	3%
Poland	Bank Gospodarki Zywnosciowej SA-Bank BGZ	10	Netherlands	COOPERATIEVE CENTRALE RAIFFEISEN-BOERENLEENBANK B.A-RABOBANK NEDERLAND	3%	8.94	2%
Romania	Banca Comerciala Romana SA-Romanian Commercial Bank SA	1	Austria	ERSTE GROUP BANK AG	24%	15.43	11%
Romania	BRD-Groupe Societe Generale SA	2	France	SOCIÉTÉ GÉNÉRALE	18%	11.10	8%
Romania	Transilvania Bank-Banca Transilvania SA	3	Romania	TRANSILVANIA BANK-BANCA TRANSILVANIA SA	10%	7.46	5%
Romania	UniCredit Tiriac Bank SA	4	Italy	UNICREDIT SPA	9%	6.35	4%
Romania	Raiffeisen Bank SA	5	Austria	RAIFFEISEN LANDESBANKEN HOLDING GMBH	9%	6.23	4%
Romania	CEC Bank SA	6	Romania	STATE OF ROMANIA	7%	6.22	4%
Romania	Alpha Bank Romania	7	Greece	HELLENIC FINANCIAL STABILITY FUND	6%	3.76	3%
Romania	Volksbank Romania	8	Austria	VOLKSBANKEN HOLDING REGGENMBH	6%	3.20	2%
Romania	Bancpost SA	9	Greece	HELLENIC FINANCIAL STABILITY FUND	4%	2.75	2%
Romania	Banca Romaneasca S.A.	10	Greece	HELLENIC FINANCIAL STABILITY FUND	3%	1.72	1%

Sources: BankScope; national sources; Haver Analytics; International Financial Statistics; World Economic Outlook database; and IMF staff calculations.

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